[127, 128] *The Commission should require that state commissions reject prices that are contribution laden. Prices that include contributions to non-economic cost subvert the provisions of the Act that rates shall be cost based.*

A number of states have adopted LRIC rules that are relatively similar (for example, the Commissions of Oregon, Texas and Michigan have adopted LRIC methodologies that are closely related) and that, in terms of methodology, could reasonably serve to approximate the relevant costs of interconnection and network elements. Nevertheless, in view of some state actions, there remains a definite need for the Commission to promulgate clear, precise, and sound principles for costing and pricing. For example, as noted in the Commission's NPRM, the New York Public Service Commission has allowed incumbent LECs to establish tariffed rates for interconnection offerings with rates based on incremental cost plus possible offsets to account for contribution loss and the impact of "stranded plant." Clearly, this degree of leeway on the part of state commissions may totally subvert the intent of the Act of 1996, which explicitly rejects this type of rate-of-return, make-whole, approach employed by the NYPSC. The Commission should prevent state commissions, pressured by incumbent LECs, from concocting costs that are a hybrid of incremental costing and make-whole provisions. (Another example of perverse costing is Ameritech's proposal cited in paragraph 129 of the NPRM. See discussion below.)

[129] *The cost of money included in TSLRIC studies provides for adequate profit when companies are <u>already</u> recovering their shared and overhead costs. The motto should be: enough is enough.*

The issue of whether additional "contribution," over and above the cost-of-money, is needed may be largely resolved by the recognition that incumbent LECs are already recovering their shared costs, overhead costs and residual costs. The fact that the incumbent LECs are already recovering these costs means that the Commission can appropriately mandate that rates for interconnection and unbundled network elements be set at TSLRIC. This is true because: (a) interconnection and unbundled network elements are new "product lines" in virtually all jurisdictions; and (b) TSLRIC does capture all additional costs incurred by the companies. In other words, there simply is no need for added mark-ups over and above the cost-of-money included in TSLRIC studies.

The Commission raises the possibility in paragraph 129 that there are significant joint and common costs among network elements. If this is true then, strictly speaking, it would be inappropriate to set *all* rates for network elements at TSLRIC. Two observations are in order, however. First, it does not seem likely that significant joint and common costs exist between network elements given the relative modularity of the network and associated functions. Second, this argument should in no way be used to justify some general level of contribution toward an unspecified amount of common or joint costs. If any joint and common costs exist between network elements and if these cost are significant, then the Commission should require that the incumbent LECs explicitly quantify these costs so that it can be determined *precisely* how much contribution would be needed.

The Commission should reject Ameritech's proposed surrogate "LRIC-based methodology" as inconsistent with the provisions of 252(d)(1). The cost categories specified by Ameritech -- joint costs, common costs, and residual costs -- are based, in part, on rate-based type of proceedings. The table below is a break-down of Ameritech's total revenue requirement into these various cost categories, as presented by Ameritech before the Illinois Commerce Commission. The Commission should specifically note the Residual cost category of $441,466,000. According to Ameritech's own testimony, Ameritech currently recovers roughly one half of a billion dollars annually that can not be justified on economic grounds; i.e., could not be recovered if telecommunications markets were competitive. In view of these data, it is clear that Ameritech's proposal is an underhanded attempt to subvert the explicit language of section 252(d)(1), which rejects rate-based type of approaches. The Commission should reject Ameritech's proposal.

Break-down of Ameritech Illinois' Costs[15]
(in thousands)

LRSIC	$1,309,663
Shared Costs	$275,866
Common Overhead	$355,747
Residual	$441,466
Total Cost	*$2,382,742*
Total Revenue	*$2,382,742*

[130] *If rates are to include mark-ups for joint and common costs, the commission should require that the incumbent LECs specify precisely how much joint and common cost they need to recover from interconnection services and network elements. In any event, Ramsey pricing is inappropriate.*

As indicated previously, the further development of competition is best served by setting rates for interconnection and network elements at TSLRIC, or as close to TSLRIC as possible. Nevertheless, if the Commission decides that mark-ups above TSLRIC are in order, then the Commission should require that the incumbent LECs specify precisely how much joint and common costs they need to recover from interconnection services and network elements. Based on this demonstration, minimum levels of contribution could be added to TSLRIC for network elements. (As will be discussed below, it makes no sense to include "contribution" levels on interconnection rates for local traffic, as the balance of traffic may be both negative or positive;

[15] *AT&T's petition for a Total Local exchange Service Wholesale Tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central telephone Company Pursuant to Section 13-505.5 of the Illinois Public Utilities Act*, D. Gebhard on behalf of Ameritech Illinois , Docket Nos. 95-0458/95-0531.

i.e., under symmetric rates, the incumbent LEC may not benefit from contribution levels if the balance of traffic is terminated on the new entrants' networks.)

In no event should the Commission adopt Ramsey pricing as a cost allocation scheme. Ramsey pricing has positive welfare properties only under a very stringent set of assumptions.[16] Most importantly, the products in case should be final products and *not* intermediate goods. Because interconnections services and network elements are intermediate goods, Ramsey pricing may well have negative welfare effects. Indeed, given the critical importance of interconnection services and network elements in the competitive strife between new and incumbent LECs, it is likely that a Ramsey pricing (cost allocation) scheme would weight the balance in favor of the incumbent LECs, thus hampering rather than furthering the development of local exchange competition. Surely, the Commission could -- and should -- adopt a more competitively neutral method for allocating joint and common costs, *if any is needed at all.*

[131] *Yes, the "reasonable profit" provision should be interpreted to mean that rates should yield reasonable levels of return on capital (including assessment of risk.)*

Indeed, any levels of return in excess of a reasonable level of return on capital would be more than stockholders "bargained" for and would result in excess earnings. As such, the resulting profits would be "unreasonable." As noted previously, because TSLRIC includes a cost-of-money component -- i.e., a reasonable level of return on capital -- rates set at TSLRIC would provide for a "reasonable profit," as required by section 252(d)(1) of the Act.

[16]See, James C. Bonbright, Albert L. Danielsen and David R. Kamerschen, Principles of public utility rates (Arlington, VA: Public Utility reports. 1988), pp. 537-38.

[132] *The determination of interim rates may distract from the determination of permanent rates, and, as such, may be counterproductive.*

(b) Proxy-Based Outer Bounds for Reasonable Rates

[134, 135, 136] *Cost-proxies in lieu of true cost studies are inappropriate. They cannot adequately reflect cost variations between LECs. The result will likely be unintended price-squeezes for competitors. Cost-proxies for establishing upper-limits, however, may be useful. Specifically, proxies may be useful when incumbent LECs' studies are not verifiable because of claims of confidentiality.*

The Commission should resist the temptation to go for the "quick fix." While the complexities of developing appropriate pricing principles are indeed overwhelming, adopting cost-proxies will likely do more harm than good. Under true competition, the success or failure of companies depends on marginal advantages or disadvantages. Given the critical dependence of new entrants on the incumbent LECs' interconnection services and unbundled network elements, highly averaged cost-proxies will invariably (and inappropriately) skew the balance of competition in favor of one or another party, possibly resulting in price-squeezes for new entrants.

Cost-proxies may be useful, however, when the studies filed by the incumbent LECs are difficult to verify because of "trade-secrets" or confidentiality claims, a frequently encountered and frustrating problem. Indeed, the Commission may want to consider a finding that declares as a rebuttal presumption the correctness of any independent studies which rely on publicly available data and methodologies and which can be readily verified by all parties. Studies provided by the incumbent LECs should only be deemed to rebut such independent studies if they too can be adequately verified by all parties.[17]

[137] *The Benchmark Cost Model has withstood cross-examination and could serve as a proxy to determine upper limits for loop costs.*[18]

[138] *Generally, interconnection arrangements should not be modelled after existing arrangements between adjacent LECs. However, some aspects of these arrangements may be carried over. In any event, all telecommunications carriers should be able to interconnect under the same terms and conditions.*

Generally speaking, the existing arrangements for interconnection between adjacent LECs are not a good model for interconnection between competing LECs. A number of aspects of the existing arrangements may be carried over, however. First, to the extent that the adjacent LECs are using "bill and keep" arrangements, these arrangements would be consistent with section 252(d)(2) of the Act.[19] Indeed, the Act explicitly contemplates "bill and keep" arrangements as appropriate (See, Section 252(d)(2)(B)(i)). Second, to the extent that the arrangements between adjacent LECs do not involve "collocation services," but rely on the LEC to furnish the

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[17]For example, the Washington Utilities and Transportation Commission rejected US West's studies in favor of the independent Hatfield Model cost studies because the latter could be verified and the former could not. Docket No. UT-950200, p. 86.

[18]The Washington Utilities and Transportation Commission found that "[t]he Hatfield Model [a variant of the Benchmark cost model] cost study identifies the Company's [US West's] true costs of providing local exchange service more closely than the Company's study, and is sufficient for purposes of pricing local exchange service." Docket No. UT-950200, FOF No. 19.

[19]For example, "bill and keep" arrangements are used between Ameritech and adjacent LECs in Michigan and Wisconsin.

necessary central office equipment to terminate incoming trunks from the other LEC, this aspect should also be adopted for interconnection between competing LECs.

The Commission should make sure, however, that all LECs will be able to interconnect under the same terms and conditions. Specifically, the historic arrangements between adjacent LECs should not be grandfathered so as to create a permanently privileged class of LECs.

[139, 140] *Using existing access rate elements as ceilings has merit only if the Commission can ensure that they will not become the de facto rates.*

As the Commission itself notes, even though some access rate elements are "reasonably cost based," the rates were established based on accounting costs rather than on forward-looking incremental costs. As such, these rates are not consistent with the provisions of the Act, which reject rate-based (accounting) type costing. Yet, establishing upper limits for interconnection services and network elements may have merit, as long as the Commission can ensure that these "ceilings" do not become the *de facto* rates in certain states.

Surely, if the Commission is to use existing switched access rate elements as ceilings, then CCLC should be eliminated from any rate ceilings for interconnection services and network elements. CCLC is for the recovery of the NTS costs associated with the local loop, a functionality not purchased by new entrants when they order interconnection services or unbundled elements (other, of course, than the loop itself.)

Because most, if not all, of the TIC is a "make-whole-subsidy" this rate element too should be eliminated. TIC should be eliminated, particularly, because the Act rejects rate-based costing the type of which the TIC represents, perhaps, the worst example.

With respect to the unbundled local switching network element, the Commission should not prejudge the rate-structure that would be most appropriate for such an element. Specifically, the concern exists that if the Commission elects the existing local switching switched access rate element -- which is measured on a per minute of use basis -- that the Commission in effect has found that switching costs are incurred on a per minute of use basis. A good argument can be made, however, that switching costs are mostly fixed costs and, therefore, that the rate structure for unbundled switching should reflect this cost structure. That is, unbundled switching should be available, perhaps, on a capacity basis rather than on a per minute of use basis.

[141] *The Commission should reject a ceiling for unbundled loops that is the sum of: (1) SLC; (2) imputed flat-rates CCL; and (3) local exchange rates. The sum of these will vastly overstate the incremental cost of most loops.*

The sum of existing state and interstate rate elements will vastly overstate the incremental costs of most loops. First, the sum of these rate elements recover more functionalities and services than just the unbundled loop that new entrants might want to order. For example, CCLC also recovers part of the NTS switch costs associated with the local loop. Because unbundled loops terminate on the main distribution frame (and separate charges may apply for cross-connects to the new entrants facilities from there), they will never use any portion of the switch. For this reason alone, CCLC overstates the allocated portion of local loop cost. Also, local exchange rates often recover costs for local calling (when flat-rated service is offered), some directory assistance services, white-page listing, etc. Again, these are *not* functionalities or services that the new entrant will receive -- indeed, the new entrant would possibly want to offer these services in competition with the incumbent LEC -- and, therefore, the new entrant should never be forced to pay for them.

Second, these rate elements are based on historic cost. Not only is this ensured to result in rates that over-recover the incremental cost of the loop, it also violates the provisions of the Act of 1996 that reject rate-based costing methods.

Third, the averaged loop rate ceilings that would result from this method would most assuredly place new entrants in a price squeeze for, most likely, 50% of the local exchange market. After all, it is in the nature of an average rate that a portion of the ratepayers has costs in excess of the average and the remainder has costs that are less than the average. Given that the average is a weighted average and certain longer loops can be many times more expensive than shorter loops, the Commission can safely assume that this averaging process will result in an anti-competitive price-squeeze for most of the local exchange markets. OPC recommends that the Commission reject the methodology contemplated in paragraph 141. Use of the disaggregated Benchmark Cost Model, mentioned in paragraph 137, would almost certainly produce more accurate results.

[142] *The development of detailed element-by-element rate ceilings may distract from developing appropriate permanent rates.*

[143] *No price floors should be adopted. Price floors could impair the ability of competition to reveal how low costs really are. Also, "bill and keep" for interconnection has no explicit rate, therefore, price floors would artificially impose rates.*

(c) Other Issues

[144] *The use of historic costs to set rates under sections 251 and 252 violate the directives of the Act. Moreover, the incumbent LECs are already recovering their historic cost. Rates in excess of incremental cost (TSLRIC) is a prescription for over-earning, and will deprive end-users of the full benefits of competition.*

First, the Act of 1996 explicitly rejects rate-based costing and pricing practices (see, section 252(d)(1)). One might wonder how much more explicit statutory language should be before incumbent LECs and policy makers abandon the obsolete notion that incumbent LECs are entitled to be made "whole." To be sure, competition and provisions that seek to keep the incumbent LEC "whole" are fundamentally incompatible. One must choose one or the other. *Congress chose competition.*

Further, incumbent LECs are already recovering their historic costs (and some seem to be recovering more than that), so that the concern about the companies' historic cost is misguided in the first place. As long as these new services -- interconnection and unbundled network elements -- recover their associated incremental costs (TSLRIC), the incumbent LECs economic viability is unaffected.

With respect to the Commission's request for the empirical magnitude of the difference between historic costs and forward-looking costs, the following should be of interest. The table below is a break-down of Ameritech's total revenue requirement into various cost categories, as presented by Ameritech before the Illinois Commerce Commission. The Commission should specifically note the Residual Cost category of $441,466,000. According to Ameritech's own testimony, Ameritech currently recovers roughly one half of a billion dollars annually that can not be justified on economic grounds; i.e., *could not be recovered if telecommunications markets were competitive.*

Break-down of Ameritech Illinois' Costs [20]
(in thousands)

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Shared Costs	$275,866
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Total Cost	*$2,382,742*
Total Revenue	*$2,382,742*

[145] *Universal service concerns should be dealt with in the Commission's Universal Service Proceeding CC Docket No. 96-45. The Commission should not contaminate the competitive process with universal service elements. New York's "play or pay" is an insidious barrier-to-entry.*

While many of the proposals to include universal service subsidies in rate elements for unbundled elements and interconnection services may be motivated by genuine concerns for

[20] *AT&T's petition for a Total Local exchange Service Wholesale Tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central telephone Company Pursuant to Section 13-505.5 of the Illinois Public Utilities Act*. D. Gebhard on behalf of Ameritech Illinois , Docket Nos. 95-0458/95-0531.

universal service, invariably they would end-up distorting the competitive process. They, most likely, will constitute barriers-to-entry. For example, New York's "play or pay" is a terribly misguided policy that makes it considerably more difficult for potential competitors to enter the market. In general:

-- "Play-or-pay" inappropriately links the preservation of universal service to the preservation of NYNEX's revenue stream, thus creating a "Bell-fare" system rather than a universal service preservation system.

-- "Play-or-pay" does not offer a long term solution to the Commission's universal service concerns.

-- "Play-or-pay" saddles New York with an inefficient telecommunications infrastructure as new entrants would be forced (induced) to serve customers *whether or not* they are the low cost providers that should serve those customers.

-- "Play-or-pay" is not competitively neutral, but favors the incumbent LEC.

-- "Play-or-pay" would force new entrants to clone themselves after NYNEX.[21] This would result in a degree of uniformity that is atypical of competitive markets. It would also reduce the benefits of competition by discouraging firms from doing what they do best, and by forcing them to do as NYNEX does, whether they are good at it or not.

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[21]To appreciate how misguided the "play or pay" proposal is, consider the following. General Motors' share of the U.S. car market is larger than its share of the U.S. truck market -- for Chrysler the opposite is true. Indeed, in 1995, Chrysler sold 786,000 cars and 1,378,000 trucks in the U.S., indicating that the company's relative strength is in truck manufacturing. Clearly, any requirement -- analogous to "play or pay" -- that all automobile manufacturers would sell the same relative percentage of cars and trucks as the market leader, General Motors, would be devastating to General Motors' competitors. For example, Chrysler, whose relative strength is in truck manufacturing, might very well be driven out of the market if it were forced to drastically scale back on truck sales and required to increase its car sales. No economist in his right mind, however, would ever recommend such a policy for the automobile industry. Unfortunately, New York's "play or pay" proposal is precisely such a policy recommendation.

The Commission should address any universal service concerns head-on in its universal service proceeding CC Docket no. 96-45. This would allow the Commission to develop universal service solutions/provisions that are truly competitively neutral.

[147, 148] *OPC agrees with the Commission that ECPR protects the incumbent LECs' shareholders at the expense of the ratepayers, which will be deprived of the benefits of competition. Also, ECPR is not cost based, and thus violates the pricing directives of the Act of 1996.*

(4) Rate Structure

[149, 150, 151] *Cost should be recovered in a manner that reflects the way they are incurred.*

OPC is in agreement with the Commission's initial conclusions that (1) rate-structures should reflect cost causation; (2) rate-structures that do not reflect cost-causation may result in subsidies between users, and thus violate the pricing directives of the Act of 1996 that rates be cost based; (3) rate-structures that do not reflect cost causation may distort the competitive process.

It is of paramount importance that the Commission provide clear directives on this issue to prevent individual state commissions for adopting irrational pricing schemes.[22]

[22]The Texas Public Utility Commission, for example, is contemplating rates for unbundled loops that are usage sensitive -- despite the long-standing, well-recognized fact that loop cost are *not* usage sensitive. TPUC Docket No. 14659, *Applications of Southwestern Bell Telephone Company, GTE Southwest, Inc. and Contel of Texas, Inc. for Usage Sensitive Loop Resale Tariffs Pursuant to PURA 1995 §3.453.*

[152, 153] *Rates that do not reflect cost may result in anti-competitive price-squeezes.*

To further promote the development of local exchange competition, it will be of increasing importance to have rate-structures adequately reflect cost-causation. The Commission's examples of the Washington Utility Commission are instructive (paragraph 152), as is the reference to AT&T's petition for a "switch platform" (paragraph 153.)

Clearly, if much of the costs of the incumbent LECs' network are capacity costs rather than usage sensitive costs, then the incumbent LECs will experience very low *marginal* costs for many of their services. Because, in truly competitive situations (such as bidding for contracts with customer specific pricing) prices may go down to marginal costs, the incumbent LECs may have a decisive advantage over dependent competitors. That is, if dependent competitors must use the incumbent LECs' networks for essential inputs, and if those inputs are priced based on average usage, then new entrants' marginal costs will in effect be based, in part, on the incumbent LECs' *average* costs, which are greater than the incumbent LECs' marginal costs.[23]

This situation can be avoided, in part, if new entrants can purchase network elements (or interconnection services) based on capacity (for example, local switching based on a per port basis rather than per minute of use). In this case, new entrants would face a cost structure that

[23]This situation exist, for example, in Chicago, Illinois. Ameritech Illinois offers its own end-users discounts on local calling that result in incremental usage rates (as low as $0.003 per minute) that are substantially below the interconnection rates of $0.0075 (tandem) and $0.005 (end-office) that competitors face on virtually every local call. Cost based interconnection rates on a per minute of use basis may not solve this problem, as Ameritech's discounts, presumably, are based on its true marginal costs of local calling.

is identical, or largely similar, to the incumbent LEC's; both would have marginal costs substantially below average costs.

This discrepancy in the costs structures of competitors, incumbent and new entrant, is particularly important in the early stages of competition when *most* of a new entrant's traffic will need to terminate on the incumbent LEC's network, or when much of the new entrants network requires unbundled network elements purchased from the incumbent.

[154] *Volume and term discounts should be permitted if they are cost based. Resellers should be allowed to aggregate to qualify for these discounts*

(5) Discrimination

[155, 156] *The Act prohibits discrimination. Discrimination is particularly objectionable when it affets the balance of competition. Discrimination between competitors and the incumbent LECs themselves is anti-competitive.*

In general, the Act prohibits any form of discrimination.[24] Before the Commission allows certain types of restrictions on interconnection or unbundled elements, it should seriously consider the competitive impact of such conditions. Particularly, restrictions in the terms and conditions faced by competitors and those implicitly enjoyed by incumbent LECs should be unacceptable as this would distort the competitive process. For example, if rates for interconnection services and unbundled elements are set above costs (TSLRIC) than the incumbent LECs would implicitly enjoy lower costs for these services and network elements.

[24]1996 Act, Section 251(c)(4)(B).

This type of discrimination would result in a competitive advantage for incumbent LECs and hamper the further development of local exchange competition.

(6) Relationship to Existing State Regulation and Agreements

[157] *The Commission should promulgate general principles that are clear, precise, and sound. Actual implementation of these principles and regulations will largely be reserved for the state commissions.*

To ensure maximum benefits from competition, OPC urges the Commission to promulgate rules that give potential entrants the opportunity to operate *viably* in all market segments and all geographic areas. Those rules should be detailed and explicit so as to establish a uniform and national telecommunication policy. consistent with the intent of the Act and the needs of new entrants.

e. Interexchange Services, Commercial Mobile Radio Services, and Non-Competing Neighboring LECs.

(1) Interexchange Services

[159 through 165] *Competition will drive all rates down to cost. The same will be true for switched access rates if the Commission allows resale of unbundled network elements. Concerns about contribution flows should be dealt with in the Universal Service proceedings, CC Docket 96-45.*

First, the Commission should take caution not to base its interpretation of the Act of 1996 (Section 251(c)(2) and the definition of the term "exchange access") on a narrow, contrived reading of the Act. Competition will drive rates down to cost. This means that if switched access rates are not currently at cost, then perhaps the Commission should not put too much effort in protecting these rates by means of legal interpretations of the Act.

Second, the Commission should consider that it will be increasingly difficult to distinguish between carriers that purchase certain functions (switched access) as local exchange carriers and carriers that purchase them as IXCs. For example, if a new entrant elects a statewide local calling scope, then calls placed by means of an IXC's network would be intrastate long distance while the same call carried by a LEC with statewide local calling scope would be a local call. It should be clear that any attempt to maintain a discriminatory rate structure between IXCs and other purchasers of essentially the same functionalities will not be sustainable as the market evolves.

The Commission should also consider the anti-competitive effects of this type of discrimination on intraLATA toll markets when IXCs compete with incumbent LECs.

To the extent that the Commission has concerns about maintaining certain contribution flows (in the form of CCLC and TIC), perhaps those concerns are better dealt with in the Commission's Universal Service proceeding, CC Docket No. 96-45. In that proceeding, the Commission can develop a competitively neutral mechanism for maintaining contribution flows, which would better serve the competitive process and be sustainable in the long run.

(2) Commercial Mobile Radio Services

[166 through 169] *The Commission should limit to the greatest extent any distinctions based on underlying technologies. Uniform principles that apply to all carriers would best serve the competitive process and be most compatible with long run developments.*

(3) Non-Competing Neighboring LECs

[170, 171] *The Commission should interpret the provisions of the Act so as to limit discrimination between classes of carriers. Specifically, adjacent non-competing LECs should not be allowed to receive interconnection based on preferential rates and conditions. Preferential rates and conditions are inconsistent with the long run development of competitive markets.*

Clearly, the distinction between non-competing neighboring LECs and competing LECs will be short-lived as incumbent LECs begin to "invade" one another's territories.[25] It is important, therefore, that *all* LECs face the same terms and conditions for interconnection services.

3. Resale Obligations of Incumbent LECs

b. Resale Services and Conditions

[174] *Yes, all LECs are prohibited from imposing discriminatory or unreasonable restrictions on resale, but only incumbent LECs are required to make such services available at wholesale rates.*

The Commission should also address the issue of when and under which conditions an incumbent LEC would be allowed to discontinue a service, both as retail and wholesale services. OPC recommends that incumbent LECs be prohibited from discontinuing services for competitive reasons. The incumbent LEC should be allowed to discontinue a service also offered for wholesale only after a public interest finding by a state commission.

[25] In Texas, for example, GTE is currently applying for a certificate to offer service in Southwestern Bell's territory in competition with Southwestern Bell. TPUC Docket No. 15760, *Application of GTE Southwest, Inc., for a Service Provider Certificate of Operating Authority*.

[175] *To establish what resale restrictions might still be reasonable, if any, the Commission should consider the question: "Would a company impose such a resale restriction if the market were truly competitive?" Further, discounted and promotional offerings should also be offered for resale to prevent anti-competitive price-squeezes.*

As the Commission rightly observes, restrictions on resale are likely to be manifestations of market power. The guiding principle in determining what restrictions are still reasonable, therefore, should be whether companies would impose such restrictions if markets were truly competitive. If the answer is no, then it is difficult to argue that such restrictions are reasonable.

The Commission should be particularly concerned about proposed restrictions on discounted and promotional offerings.[26] In many instances the current tariffs of the incumbent LECs do already include discounts for a variety of services such as Centrex services (which often involve customer specific contracts, subject to limited or no rate-review by commission staff), vertical features, or local calling discounts for business customers. Those discounts can be substantial.[27]

With respect to those discounts, two points are in order. First, these discounts -- offered by incumbent LECs for competitive reasons -- should be viewed as an indication of the percentage discounts incumbent LECs are prepared to give *when it suits their business interests.*

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[26]For example, Ameritech Illinois, ICC Docket. No. 95-0458, Direct Testimony Mr. T. O'Brien, pp. 14-15.

[27]For example, Ameritech Illinois offers retail discounts of over 20 percent on packages of custom calling features to business customers. The maximum discount lowers the effective retail rate below the wholesale rate offered to resellers. Illinois Bell Telephone Company Tariff ILL.C.C. No.5, Part 2, Section 9, Page 18.

Second, the Commission should be aware that these discounts may well be larger than the discounts that will be offered to resellers. If they are, then *prima facie* evidence exists of a anti-competitive price-squeeze.[28] In any event, retail discounts, that are not further discounts for wholesale purposes, will reduce the margins available to resellers.

The potential for this type of anti-competitive pricing is further facilitated by the fact that for many services, such as vertical features that will be so effective in attracting or *retaining* customers, the real costs to the incumbent LEC will be substantially below the wholesale discount rates offered to resellers.[29] That is, in many instances incumbent LECs will be able to offer retail rates below wholesale rates and still make a handsome profit on the service. One might dub this "painless predation."[30]

In short, if the Commission is serious about promoting local exchange competition also by means of resale competition, then the Commission should order incumbent LECs to offer for resale any discounted and promotional packages. To be sure, in the absence of a regulatory

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[28]For example, Ameritech Illinois offers both volume and off-peak discounts on local calling. The combined discounts result in effective retail rates that are *substantially* below the wholesale rates offered to resellers. Retail Tariff Illinois Bell Telephone Company, ILL.C.C. No.5, Part 2, Section 19, Page 33.05. Wholesale Tariff, ILL.C.C. No. 20, Part 22, Section 4, Sheet No. 3, Paragraph 2.4.

[29]For example, the monthly cost of offering vertical features is sometimes less than a fraction of a penny. See testimony of Ameritech Illinois's cost-witness Palmer, ICC Docket No. 95-0458, Exhibit 7.4a, pp. 2-7. The corresponding wholesale rates are typically $1.98 per month. This creates an enormous margin for Ameritech to undercut the wholesale rates and to do so profitably.

[30]"Predation" typically involves the *painful* practice of selling a product *below* cost in order to drive competitors out of the market.

requirement to further discount retail discounts for wholesale purposes, incumbent LECs will "run circles" around their competitors. They will exercise their "trump card," and offer promotional packages in all circumstances where they really want and need to retain customers, such as larger business customers.

[176] *In general, any discrimination is prohibited by the Act. Certain "reasonable" restrictions on resale may be justified if they do not seriously affect the balance of competition and are based on sound public policy considerations.*

It seems appropriate to limit the resale of demonstrably subsidized services, such as those under the Lifeline program. This also seems to be the intent of the Act of 1996, section 251(c)(4)(B). In general, however, the Commission should be extremely cautious in allowing restrictions on resale.

[177] *Resale restrictions on residential services limits competition for a customer class that most needs the protection of competition.*

Limiting resale of residential services, even to residential end-users, is counter-productive. Clearly, the great challenge faced by the Commission, and by the state commissions, is: How to introduce competition, which tends to emerge most easily in urban and business markets, without raising rates to residential and rural customers? One way to resolve this situation of potentially conflicting objectives is to harness the forces of competition in efforts to protect residential customers. That is, if effective competition can also be introduced in residential and rural markets, policy makers have to worry less about undesirable and adverse impacts on these customer classes.

Nevertheless, it does not seem unreasonable to limit, for an intermediate period, the resale of flat-rated residential services to business customers. Eventually, however, any distinction that is not cost-based will be unsustainable as markets become more competitive. (Not to mention the fact that many people that work at home might already be using residential services for business or job related purposes.) It behooves regulators, therefore, to anticipate that the distinction between business and residential services will disappear.

Also, the Commission should note that any restrictions on the resale of flat-rated residential service to business customers is predicated on the notion that the former service is subsidized. If flat-rated residential service is not subsidized, however, then there is no obvious reason for why resale of this service should be retricted. Further, the establishment of a competitively neutral funding mechanism for universal service would also remove the justification for any resale restrictions on flat-rated residential service. Once the subsidies for this type of service, assuming subsidies exists, are made external to the incumbent LEC, the service should be available for resale. After all, between payments from the reseller and the universal service fund, the incumbent LEC should be able to recover all of its costs. Thus, it would be appropriate to re-visit this issue at a later date.

c. Pricing of Wholesale Services

(1) Statutory Language

[178] *Yes, the Commission is authorized to promulgate rules for the states in applying section 252(d).*

(2) Discussion

[179, 180] *Many resellers will operate nationwide. It is important that they encounter uniform conditions and policies. This allows for greater efficiency and facilitates competitive entry. The Commission's policies, therefore, should guide the state commissions. Avoided costs should also reflect a reduction in general overhead costs.*

As a hypothetical, if an incumbent LEC were to loose all of its end-users to a reseller, then, clearly, the incumbent LEC's overhead costs can be reduced. This hypothetical demonstrates that overhead costs are avoidable proportional to other avoidable costs. The wholesale discounts, therefore, should also reflect a reduction in general overhead costs.

[181] *At a minimum, the commission should identify specific accounts of the Commission's USOA that are avoidable or partially avoidable.*

[182] *To the greatest extent possible, discounts should be calculated on a service-by-service basis. Average discounts will result in anti-competitive price-squeezes.*

[183] *A limited application of the avoided cost method is equivalent to the Efficient Component Pricing Rule, already rejected by the Commission. (See Paragraph 147, 148.) The Illinois staff's recommendations, that involve an allocation of overhead and contribution, are appropriate.*

The Illinois Staff's recommendations are consistent with the provisions of the Act. They also adequately deal with a major problem of calculating discounts based on a reading of the Act that would only consider certain types of costs as avoidable but ignore that certain overhead costs are also partially avoidable. That is, basing discounts strictly on a narrow set of avoided costs *preserves* the earnings stream of an incumbent LEC. In this sense, a limited application of the avoided cost method is virtually identical to an application of the Efficient Component Pricing Rule, already rejected by the Commission in paragraphs 147 and 148 of its Notice. By contrast, the recommendations by the Illinois Staff will partially subject the earnings of the incumbent LECs to competitive pressures, thus increasing the societal benefits of competition.

Further, because the avoided cost method, by construction, tends to preserve most of the earnings of the incumbent LEC, the Commission should consider ordering the incumbent LECs to absorb the implementation costs of establishing wholesale tariffs. This recommendation ensures that the incumbent LECs have the correct incentive structure with respect to these types of costs. That is, if the incumbent LECs are ordered to absorb the implementation costs (recover them out of the earnings of the resale products), then they have the proper incentives to keep those costs low. By contrast, if incumbent LECs are allowed to "flow through" implementation costs to competitors, then a perverse incentive structure is created, which encourages LECs to inflate their implementation costs. The higher those costs are, the more difficult it will be for competitors to compete.

(3) Relationship to Other Pricing Standards

[184 through 186] *Under the Act, wholesale rates are to be determined "top-down" and rates for unbundled network elements are to be determined "bottom-up." Imputation is necessary to avoid price-squeezes and price-discrimination.*

The avoided costs method prescribed for resale, in essence, a "top down" approach to costing/pricing. By contrast, under the Act, prices for unbundled network elements (and interconnection services) should be determined based on the incremental cost, which is a